90-1825

No. _____

Supreme Court, U.S.
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In the
Supreme Court of the United States
October Term, 1990

NORTHWEST RACQUET SWIM &
HEALTH CLUBS, INC.,

Petitioner,

v.

RESOLUTION TRUST CORPORATION, as receiver for
MIDWEST FEDERAL SAVINGS AND LOAN
ASSOCIATION,
a United States corporation, and
MIDWEST SAVINGS ASSOCIATION, F.A.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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QUESTIONS PRESENTED

1. Does a purchaser of subordinated debt securities from a now insolvent federal savings and loan association have the right of rescission and the remedy of restitution upon the proof of fraud in the inducement to purchase?

2. Assuming a purchaser of subordinated debt securities has the right of rescission and the remedy of restitution, is the holder of that security elevated to the status of a general creditor?

LIST OF PARTIES AND RULE 28.1 LIST

The parties to the proceedings below were the Petitioner Northwest Racquet Swim & Health Clubs, Inc., a Minnesota corporation, and the Respondents Resolution Trust Corporation, as receiver for Midwest Federal Savings and Loan Association and Midwest Savings Association, F.A.

This action was originally commenced against Midwest Federal Savings and Loan Association of Minneapolis, a United States corporation. The Complaint was subsequently amended to add Midwest Savings Association, F.A., a newly chartered federal savings bank, as a party. The answer was submitted by Midwest Federal Savings and Loan Association of Minneapolis by its receiver, Federal Savings and Loan Insurance Corporation. Federal Savings and Loan Insurance Corporation, conservator for Midwest Savings Association F.A., was substituted for Defendant Midwest Savings Association, F.A. During the pendency of this action, Congress created the Resolution Trust Corporation. Consequently, Resolution Trust Corporation replaced Federal Savings and Loan Insurance Corporation as receiver for Midwest Federal and conservator of Midwest Savings. Resolution Trust Corporation is the present Respondent.

Petitioner Northwest Racquet Swim & Health Clubs, Inc., a Minnesota corporation, has no parent companies, subsidiaries, or affiliates to list pursuant to Rule 28.1.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

The Petitioner Northwest Racquet Swim & Health Clubs, Inc. (Petitioner) respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Eighth Circuit entered in the above-entitled proceeding on February 28, 1991.

OPINIONS BELOW

The opinion of the Court of Appeals for the Eighth Circuit is reported at 927 F.2d 355 and is reprinted in the appendix hereto, *infra* p. A-3.

The September 25, 1989 memorandum decision of the United States District Court for the District of Minnesota (MacLaughlin, D.J.) is reported at 721 F.Supp. 211 and is reprinted in the appendix hereto, *infra* p. A-20. The December 5, 1989 memorandum decision of the United States District Court for the District of Minnesota (MacLaughlin, D.J.) has not been reported. It is reprinted in the appendix hereto, *infra* p. A-35.

JURISDICTION

This action was originally brought by Petitioner in Minnesota State Court. It was removed to the United States District Court, District of Minnesota, Fourth Division, on the petition of Respondent Federal Savings and Loan Insurance Corporation (FSLIC), as receiver for Midwest Federal Savings and Loan Association of Minneapolis (Midwest Federal). The bases asserted for federal court jurisdiction are 12 U.S.C. Sec. 1730(d)(1), 28 U.S.C. Sec. 1331 and 28 U.S.C. Sec. 1346. After removal, the Complaint was amended to add a claim for rescission grounded upon violation of federal securities statutes, 15 U.S.C. Sec. 78j and 17 C.F.R. 240.10b-5.

Respondent FSLIC, as conservator for Midwest Savings Association (MSA), brought a motion to dismiss under Fed. R. Civ. P. 12(b)(6). Petitioner sought to enjoin Respondents pursuant to Fed. R. Civ. P. 65 and 67 from selling or transferring notes which were the subject of Petitioner's claim for setoff, and from declaring the notes as being in default, with interest to be paid into court. By judgment dated September 25, 1989, the district court granted FSLIC's motion to dismiss pursuant to Fed. R. Civ. P. 56 and denied

Petitioner's request for a preliminary injunction. Petitioner, by notice of appeal dated October 19, 1989, appealed that decision to the United States Court of Appeals for the Eighth Circuit pursuant to 28 U.S.C. Sec. 1292(a)(1).

Subsequently, Respondent Resolution Trust Corporation (RTC), as receiver for Midwest Federal, brought a motion for summary judgment pursuant to Fed. R. Civ. P. 56. By judgment entered November 22, 1989, the district court granted the requested summary judgment and entered final judgment. Petitioner, by notice of appeal dated November 28, 1989, appealed the entry of final judgment to the United States Court of Appeals for the Eighth Circuit pursuant to 28 U.S.C. Sec. 1291 and sought consolidation of the two appeals, which was granted.

On February 28, 1991, the United States Court of Appeals for the Eighth Circuit entered a judgment and an opinion affirming the Minnesota District Court judgment. No petition for rehearing was sought.

The jurisdiction of this Court to review the judgment of the Eighth Circuit is invoked under 28 U.S.C. Sec. 1254(1).

STATUTES AND REGULATIONS INVOLVED

15 U.S.C. Sec. 78j. Manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange ——

***

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so

registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

17 C.F.R. 240.10b-5. Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

12 C.F.R. Sec. 563g.10 (1988) Unsafe or unsound practices.

It shall constitute an unsafe or unsound practice within the meaning of section 5(d) of the Home Owner's Loan Act of 1933 (12 U.S.C. 1464(d)) and section 407(3) of the National Housing Act of 1934 (12 U.S.C. 1730(e)) for any person, directly or indirectly,

(a) To employ any device, scheme or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make statements made, in light of the circumstances under which they were made, not

misleading, or

(c) To engage in any act, practice, or course of business which operates as a fraud or deceit upon any person, in connection with the purchase or sale of any security of an insured institution. Nothing in this section shall be construed as a limitation on the applicability of section 10(b) of the Exchange Act (15 U.S.C. 78j(b)) or Rule 10b-5 promulgated thereunder (17 C.F.R. 240.10b-5).

Minnesota Statute Sec. 80A.23 (1990). Civil liabilities.

Subdivision 1. Any person who sells a security in violation of sections 80A.08 or 80A.18, or of any condition imposed under section 80A.11, subdivision 4, or 80A.12, subdivisions 5 and 6, is liable to the person purchasing the security, who may sue either in equity for rescission upon tender of the security or at law for damages if that person no longer owns the security. In any action for rescission, the purchaser shall be entitled to recover the consideration paid for the security together with interest at the legal rate, costs, and reasonable attorney's fees, less the amount of any income received on the securities. In an action at law, damages shall be the consideration paid for the security together with interest at the legal rate to the date of disposition, costs, and reasonable attorney's fees, less the value of the security at the date of disposition.

STATEMENT OF THE CASE

This action is one for restitution upon rescission of a $15 million subordinated debt security purchased in 1987 from Midwest Federal, a federally insured savings and loan association which was declared insolvent in February, 1989 and subsequently placed in receivership on May 4, 1989. The ground for rescission is fraud in the sale of the security in violation of state and federal securities law statutes. Petitioner, the purchaser of the security, contends that since it declared its rescission on the ground of fraud while the thrift institution remained open for business, it should, upon proof of its claim, be treated as a general creditor of the institution, not a subordinated note holder. Petitioner grounds its contention on this Court's decision in *Oppenheimer v. Harriman Nat'l Bank & Trust Co.,* 301 U.S. 206 (1937). The lower courts rejected Petitioner's contention, ruling that Petitioner was "not entitled to any relief" because subordinated debt was treated as "capital" under Federal Home Loan Bank Board (Bank Board) regulations although acknowledging that Petitioner was, along with others, a "victim" of the institution's fraud. (*infra* p. A-14.)

On December 29, 1987, Petitioner, a developer and operator of health clubs, purchased a $15 million subordinated debt security from Midwest Federal, a Minneapolis based, federally insured savings and loan association. Petitioner had a long term banking relationship with Midwest Federal centered upon financing the acquisition and development of its health clubs over a period of twenty years. The debenture, by its own terms, subordinated Petitioner's credit status in the event of liquidation "to all claims against [Midwest Federal] having the same priority as savings account holders or any other higher priority."

Petitioner purchased the subordinated debt security in reliance upon representations made in Midwest Federal's Subordinated Debt Securities Agreement and on assurances from various executives of Midwest Federal to

the effect that Midwest Federal was in good financial condition and continuing to gain financial strength. The representations turned out to be false. At the time it sold the subordinated debentures, Midwest Federal knew, but concealed, that certain assets were substantially overstated in the representations to Petitioner. If Midwest Federal's true status had been known to Petitioner, it would not have purchased the security. Moreover, it is unlikely the Bank Board, as the thrift industry's regulator, would have sanctioned the sale had it known in 1987 that Midwest Federal was concealing its failing finances.

Midwest Federal's fraud in this instance has not been explicitly conceded by Respondents. The truth of the allegation of fraud in violation of Sec. 10b of the Securities and Exchange Act of 1934 and in violation of Minnesota's securities fraud statute, however, has been assumed in considering the issues in the lower courts.

Midwest Federal defaulted under the Agreement when it failed to produce audited financial statements for 1987 and 1988 and finally failed to pay interest in 1989. It is undisputed that the subordinated debt security sold to Petitioner for $15 million is, and always was, worthless.

On January 25, 1989, Petitioner declared the subordinated debenture to be in default by virtue of a "breach of representations and warranties" and a "failure to furnish financial statements and certificates" in accordance with the Agreement. This declaration accelerated Petitioner's right to repayment. Petitioner executed two promissory notes (Notes) for $10 million and $49 million on December 1 and December 10, 1987, respectively. Petitioner directed Midwest Federal to set off the entire unpaid balance of its Notes against the subordinated debt security. On February 13, 1989, the Bank Board, RTC's predecessor as regulator of federally chartered thrifts, determined that Midwest Federal was insolvent and appointed FSLIC as the conservator for Midwest Federal. The thrift remained open for business under FSLIC management until its receivership was declared on May 4, 1989.

On March 10, 1989, in the wake of increasing publicity about fraud at Midwest Federal in the valuation of assets, Petitioner tendered the subordinated debt security in rescission to FSLIC as conservator for Midwest Federal. The letter stated that Petitioner had reasonable grounds upon which to conclude that the sale of the subordinated debt security "involved the misrepresentation of material facts and willful failure to disclose material facts known to [Midwest Federal]." At the time of this notice of rescission, Midwest Federal had not closed but was operating fully under the conservator's management.

On April 19, 1989, Petitioner commenced this action against Midwest Federal in Minnesota State Court seeking a decree ordering restitution upon rescission of the sale of the subordinated debt security pursuant to Minn. Stat. Sec. 80A.23 -- civil liabilities for securities fraud. Petitioner also sought a judicial declaration under Minnesota's Declaratory Judgment Act that the amount due in restitution to Petitioner upon rescission of the subordinated debt security be set off against the Notes executed by Petitioner in favor of the thrift.

On May 4, 1989, the Bank Board closed Midwest Federal and appointed FSLIC as receiver for Midwest Federal. On that same date, the Bank Board chartered a new thrift, the Respondent MSA and appointed FSLIC as its conservator. FSLIC, under the terms of a "Purchase and Assumption Agreement," transferred Midwest Federal's valuable assets to MSA in consideration of the assumption by MSA of the liabilities of Midwest Federal, exclusive of the subordinated debt. Although the Agreement is not precise in this regard, obligations to make restitution to remedy fraud by Midwest Federal apparently have been assumed by MSA. This transaction crystallized the issues in this lawsuit. As the holder of a subordinated debenture, Petitioner would have possessed a claim against a receiver who no longer held assets covering the claim. Subordinated note holders stood to receive nothing. On the other hand, MSA holds the assets and promised to pay the general creditors upon liquidation.

If the debenture was rescinded on the ground of fraud, Petitioner would be owed restitution, not subordinated debt, and would share ratably in this liquidation along with other general creditors. Petitioner would also be entitled to assert the right of setoff.

Petitioner amended its complaint to add MSA as a party. It also added a count seeking a decree rescinding the sale of the subordinated debt security pursuant to sec. 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. Sec. 78j(b) and Rule 10(b) of the Securities and Exchange Commission, 17 C.F.R. Sec. 240.10b-5. Prior to Respondents' removal to federal court, rescission had been predicated on Minnesota state statutes and common law.

Petitioner brought before the district court a motion requesting an order, pursuant to Fed. R. Civ. P. 65, enjoining the sale or transfer by MSA of the Notes which are the subject of the claim for setoff. Petitioner also moved for an order pursuant to Fed. R. Civ. P. 65 and 67 allowing Petitioner to make interest payments on the $10 million Note, which is the subject of its claim for setoff, into court and enjoining Midwest Federal from declaring the loans from being in default. Petitioner argued that it was entitled to rescission because of false representations and misleading omissions by Midwest Federal in the sale of the subordinated debt securities. Evidence of this fraud was submitted in support of the motion and has not been refuted by Respondents. Petitioner cited directly to this Court's decision in *Oppenheimer v. Harriman Nat'l Bank and Trust Co.,* 301 U.S. 206 (1937) to support its contention. The right of rescission is firmly ensconced as a remedy for the fraudulent sale of securities under both federal and state law.

FSLIC, as conservator for MSA, brought a motion to dismiss under Fed. R. Civ. P. 12(b) (6). In its motion, FSLIC asserted, among other arguments, that Petitioner should be estopped from rescinding because the debt was used by Midwest Federal to comply with the Bank Board's regulatory capital requirements. In the topsy-turvey world

of thrift accounting standards, subordinated debt is considered "capital" in assessing the financial strength of a thrift even though such debt would be necessarily treated as a liability under Generally Accepted Accounting Principles ("GAAP"). *See* 54 Fed. Reg. 34,148 (1989) (commentary accompanying Final Rule amendments to regulations governing the issuance and use of subordinated debt (codified at 12 C.F.R. Sec. 563.13 (1989))).

In response to this assertion, the Petitioner's president and secretary filed affidavits stating that at no time did anyone speaking on behalf of Midwest Federal "state or imply that a subordinated debt investment by [Petitioner] was necessary either to meet regulatory financial requirements or to allow Midwest to continue in business." It is undisputed that the financial information provided by Midwest Federal to Petitioner disclosed no deficiency in regulatory capital.

By order dated September 25, 1989, the district court granted MSA's request for summary judgment dismissing Petitioner's setoff claim. (*infra* pp. A-20) The district court concluded that regardless of Midwest Federal's fraud, a rescission due to fraud in the sale of the subordinated debt securities would not elevate the purchaser to the status of a general creditor. Since the district court would not consider Petitioner to be a general creditor, Petitioner could not exercise setoff because of the lack of mutuality of obligation. Based on that conclusion of law, the district court denied Petitioner's motion for a preliminary injunction enjoining the sale or transfer of the Notes subject to Petitioner's claim for setoff. Petitioner appealed the denial of its request for preliminary injunction and grant of summary judgment to the United States Court of Appeals for the Eighth District.

While injunction denial was pending on appeal, and following the enactment of the Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA), the district court ordered that RTC be substituted as the defendant receiver. RTC then brought a motion for

summary judgment before the district court contending that the district court's analysis in granting summary judgment in favor of MSA applied with equal force to claims asserted against the receiver and, therefore, summary judgment for the receiver was appropriate.

By order filed November 22, 1989, the trial court granted RTC's motion ruling that where subordinated debt was used by a thrift as "regulatory capital," the defrauded investor was "estopped" from seeking rescission and restitution under the anti-fraud provisions of both federal and state securities law. (*infra* pp. A-38.) The district court entered final judgment. (*infra* pp. A-34.) Petitioner appealed the judgment to the United States Court of Appeals for the Eighth Circuit. Both appeals were consolidated for decision. The United States Court of Appeals affirmed. (*infra* pp. A-3)

The Eighth Circuit, in affirmance, held that Petitioner was not entitled to any relief because the subordinated debenture was used as regulatory capital by Midwest Federal and that the declaration of rescission had not been made until after appointment of the conservator, even though the thrift was being operated as a "going concern." (*infra* pp. A-10-19.) The Court of Appeals acknowledged that Petitioner, no less than the depositors, was a "victim of the institution's fraud." The Court determined that the question was which party should receive priority in the settlement of their claims: "the investor, who is in the best position to judge the condition of the thrift and influence its management, or the innocent depositors and general creditors." (*infra* pp. A-14-15.) The Court of Appeals concluded that the defrauded investors in subordinated debt had to surrender their rights and remedies under federal and state securities law. In the Eighth Circuit's words:

> In such situations, fairness and equity dictate that investors, having undertaken the greater risk, give way to the depositors and general creditors by honoring the regulatory obligations they have assumed. It is the regulatory interest of protecting the

innocent depositors and general creditors which drove the Second Circuit's analysis in *Weis* which we now adopt.

(*infra* pp. A-15.) The Eighth Circuit rejected, in a footnote, Petitioner's analysis based on this Court's decision in *Oppenheimer,* choosing instead to adopt the Second Circuit's analysis of a different statutory scheme set forth in *In re Weis Securities, Inc.,* 605 F2d 590 (2d Cir. 1978), *cert. denied,* 439 U.S. 1128 (1979). (*infra* pp. A-14.) There is no statutory authority, and the Court of Appeals cited none, empowering the Court to adjudicate priority in the liquidation of a thrift institution.

REASONS FOR GRANTING THE WRIT

I.

The Eighth Circuit's Refusal To Allow Petitioner To Rescind And Seek Restitution For The Fraudulent Sale Of Subordinated Debt Securities Conflicts With A Decision Of This Court, Other Circuits, And State and Federal Securities Statutes.

The decision in the Eighth Circuit is contrary to a decision of this Court, the Ninth Circuit Court of Appeals and the legislative actions the Eighth Circuit sought to interpret. The Eighth Circuit's holding that fraud in the sale of securities of a bank or thrift institution may not be redressed under federal and state antifraud statutes represents the first instance where a court has discriminated against a fraud victim solely because of the class of security used as an instrument of the fraud. Such an unprecedented holding deserves this Court's attention.

The Eighth Circuit's decision is driven by its argument that the claims of the "innocent" depositors and other general creditors are superior to the claims of defrauded debenture holders. The Court of Appeals acknowledged a "regulatory interest" in denying the remedy of restitution

to subordinated debtholders in an insolvent thrift. (*infra* pp. A-15.) In coming to its conclusion, the Eighth Circuit trod heavily upon this Court's opinion in *Oppenheimer,* the authority of which is now quite confused. Indeed, the Court of Appeals adopted the principal arguments of the conservator for the Harriman Bank, which had been explicitly rejected by the opinion of this Court in *Oppenheimer.* For example, the Harriman Bank argued:

> [A]dmitting the claim of a defrauded shareholder to an equal ranking with the claims of depositors would seem to contravene the express solicitude of Congress for the claims of depositors of insolvent national banks. Congress, desiring to preserve from depletion the assets necessary to pay *depositors,* has provided that claims of the United States for taxes may not be asserted if the effect will be to diminish the assets necessary for the full payment of all depositors. (12 U.S.C. Sec. 570, Act on March 1, 1879, c. 125, Section 22, 20 Stat. 351). Petitioner Harriman's Brief to the United States Supreme Court at 49. (Emphasis in the original).

This Court rejected that argument finding no clear congressional intent in that regard. This Court stated:

> The statutes relied on by defendant cannot reasonably be construed to forbid rescission of fraudulent sales by national banks of their own stock. In the absence of language unquestionably disclosing that purpose, Congress may not be held to have so intended. There is no evidence of that intention. Defrauded purchasers may rescind fraudulent sales by national banks of their own capital stock.

Oppenheimer, 301 U.S. at 211-212. In this case, the Eighth Circuit ruled that:

> In such situations, fairness and equity dictate that investors, having undertaken the greater risk, give way to the depositors and general creditors by honoring the regulatory obligations they have

assumed. (*infra* pp. A-15.)

The conflict between *Oppenheimer* and the instant case could not be more complete. In fact, this case presents a stronger case for rescission upon fraud based on the present statutes and regulations than did *Oppenheimer*. As previously stated, *Oppenheimer* arose before the Securities and Exchange Act of 1934 and its declaration of a federal policy in favor of a remedy for securities fraud. A defrauded investor has more support in state and federal statutes for rescission upon fraud today than existed to support Mr. Oppenheimer in the 1930's when the Harriman Bank failed. By contrast, the laws governing the liquidation of an insolvent national bank in the 1930's and the laws governing Midwest Federal's liquidation currently evince similar regulatory interests. If anything, the Securities and Exchange Act of 1934 tilted the balance of policy in favor of the defrauded investor.

There is no historical evidence to argue that today's regulatory concerns in liquidation of a bank or thrift, as found in any statute or regulation, justify subordination of the remedies ordinarily available to defrauded investors. The Eighth Circuit does not make and could not have made reference to any federal or state statute supporting its decision to bar the remedy of rescission for defrauded subordinated note holders. Indeed its decision bars, without comment, an express remedy under Minnesota state statutes. The Eighth Circuit did not reference the regulations governing the thrift industry which explicitly acknowledge that the industry's regulator intends no limitation on the applicability of the antifraud provisions of federal securities law. The regulatory sections governing the Bank Board[1] specifically state that neither the savings institution nor any persons with the institution are to

[1] The Federal Home Loan Bank Board acted as the principal regulator of the federal savings and loan industry until August 9, 1989, when Title IV of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub.L. No. 101-73, 103 Stat. 354, became law, abolishing the Bank Board and replacing it with the Office of Thrift Supervision.

engage in any act, practice or course of business which operates as a fraud or deceit upon any person in connection with the purchase or sale of any security of an insured institution. The regulation further provides that nothing in that section is to be construed as a limitation on the applicability of Rule 10b-5 of the Securities Act, 12 C.F.R. Sec. 563g.10(c). In the name of "regulatory interests," nonetheless, the Eighth Circuit has imposed limitations which the regulator itself has eschewed.

Equally in conflict with the decision below is *Federal Deposit Ins. Corp. v. United States Bank,* 685 F.2d 270 (9th Cir. 1982). In that case, the Ninth Circuit held that the FDIC's position as receiver for a subordinated debt holder was properly rescinded upon a showing of fraudulent inducement in the sale of subordinated securities to the investing bank. Upon such rescission the court found the FDIC as a fraud victim entitled to status as a "general creditor," a result "fully supported" by *Oppenheimer. Id.* at 273.

The Eighth Circuit adopted the Second Circuit's analysis in *In re Weis Securities Inc.,* 605 F.2d 590 (2d Cir. 1978), *cert. denied,* 439 U.S. 1128 (1979). In *Weis,* subordinated lenders brought an action against the trustee of a failed broker-dealer claiming fraud and seeking rescission of its subordinated notes. The broker-dealer had borrowed money on a subordinated basis to enhance "capital" for determination of its compliance with the "net capital rules" of the SEC and the New York Stock Exchange. In *Weis,* subordinated loans were made to the failed broker-dealer for the specific purpose of "enabling" the broker-dealer to comply with net capital rules. 605 F.2d at 593. The Second Circuit held that under these facts, when a lender subordinated a loan made to the securities broker to enable the broker to comply with regulatory capital requirements, the lender was estopped from rescinding the subordination agreement. *Id.* at 596-97. The Eighth Circuit acknowledged it was extending *Weis* by discarding the element of specific intent of the lenders. (*infra* pp. A-15-16.)

Although not brought forward in the Eighth Circuit's opinion, *Weis* is also distinct from the instant case because the SEC, the regulator in *Weis,* had "proscribed" rescission of subordinated debt by "mutual consent or otherwise." 605 F.2d at 596.

The Eighth Circuit also cited this Court's 1901 decision in *Scott v. Deweese,* 181 U.S. 202 (1901). In *Scott,* this Court held that Scott, as stockholder in a national bank, could not escape liability for assessment as a stockholder when the national bank became insolvent. In that case, when Scott learned that the shares of stock which he held were part of an increase in capital which was made without compliance with the conditions of the Act of May 1, 1886, Scott disclaimed liability and denied that he was or ever had been a stockholder in the bank. This Court held that Scott must pay the assessment on shareholders, a ruling explicitly confirmed but enlarged in *Oppenheimer.*

Oppenheimer, unlike *Scott,* went on to address the next issue -- whether Oppenheimer, who without complaint paid assessment liability, was entitled to rescission and restitution for fraud in the inducement. This Court concluded that Scott's liability to pay the assessment had not barred the right to rescind. Upon rescission, Oppenheimer shed his subordinated status and was entitled to be treated equally with the other general creditors. *Oppenheimer,* 301 U.S. at 215.

It is undisputed that Petitioner, like Mr. Oppenheimer, has met all obligations of performance under its subordinated debt securities agreement with Midwest Federal. *Scott* is not pertinent to this controversy. Petitioner has the right to exercise its right of rescission and stand on par with other general creditors.

In summary, the Eighth Circuit ruling is contrary to federal and states securities laws and ignores federally enacted regulations which require savings and loans to fully and fairly disclose to purchasers their financial situation. By the creation of an "exception" to ordinary remedies for fraud, in the case of junior securities issued

by regulated financial institutions, the Eighth Circuit has introduced into securities law the concept that the priority of a security may be determinant in establishing whether a remedy for fraud is available in the sale of such securities. It is a precedent directly at odds with this Court's ruling in *Oppenheimer* and the Ninth Circuit's holding in *Federal Deposit Ins. Corp.* Plenary consideration of this matter by this Court is essential.

II.

The Holding That Defrauded Purchasers Of Equity Or Subordinated Debt Securities Issued By Regulated Financial Institutions Are Not Entitled To Pursue Common Law and Statutory Remedies Presents An Issue Of National Importance.

The Eighth Circuit has held, in essence, that it may override established statutory remedies for securities fraud because it perceives a countervailing "regulatory interest." In this instance, the interest being elevated is that of the Respondent, the Resolution Trust Corporation. This principle of law, however, has ramifications that clearly transcend the problems of the moment.

Industries other than savings and loans will certainly encounter difficulty in the future to a degree capable of motivating a court to vindicate a "regulatory interest." This notion of smoldering equity runs counter to the purposes of the federal and state securities laws which were designed to assure and maintain confidence in the integrity of the capital markets of the United States' economy. The Eighth Circuit has viewed the issue as one of "fairness and equity" as it perceives this passing controversy. Petitioner sees itself as seeking a traditional, well established remedy presumably beyond the reach of a court to remove simply because other claimants are perceived presumptively more "innocent" at the moment.

Petitioner is reminded of then Justice Rehnquist's classic definition of "simple justice": " 'Simple justice' is achieved when a complex body of law developed over a period of years is evenhandedly applied." *Federated Dep't Stores Inc. v. Moitie,* 452 U.S. 394, 401 (1981). Similarly here, the application of state and federal securities law serves vital public interests beyond any individual court's ad hoc determination of the equities in any particular case. The question of whether the securities of certain industries are redressable in insolvency under the antifraud statutes enacted by Congress and the several states raises concerns of national policy and impact. Guidance by this Court is needed.

CONCLUSION

For these various reasons, this petition for certiorari should be granted. If the Petitioner is correct in urging that it is entitled to the remedies available to it under the antifraud statutes of the United States and Minnesota, this matter should be remanded to the district court for determination on the merits.

Respectfully submitted,

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United States Court of Appeals
For the Eighth Circuit

U.S. Court & Custom House
Robert D. St. Vrain 1114 Market Street (314) 539-3600
Clerk St. Louis, Missouri 63101 FTS: 262-3600

February 28, 1991

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Re: Nos. 89-5526/5585MN Northwest Racquet Swim & Health Clubs, Inc. v. Resolution Trust Corp.

Dear Counsel:

Enclosed is a copy of the opinion filed today in the referenced case. Judgment in accordance with the opinion is also entered today.

Please review Federal Rules of Appellate Procedure 35 and 40 and Eighth Circuit Rules 35A and 40A. Petitions for rehearing *must* be received by the clerk's office within the time set by FRAP 40 (within 14 days of entry of judgment) unless extended by court order. Petitions for rehearing or motions to extend the time for filing rehearing requests are not afforded any grace period for mailing and are subject to being denied if not timely received. Please review Eighth Circuit Rule 35A(d) if an en banc request is contemplated.

You are also directed to Federal Rule of Appellate Procedure 39 and Eighth Circuit Rules 28A(1) and 30A(3). Itemized and verified bills of costs are to be filed with this office with proof of service **within 14 days from this date.** Counsel for the prevailing party should **promptly** forward to us an itemized bill of costs for the reproduction

of the authorized number of copies of their briefs. Failure to submit an itemized bill of costs will result in waiver of costs. Untimely itemized bills of costs will not be processed without a special order of the Court. Objections to requested bills of costs must also be submitted on a timely basis, within 10 days of the bill of costs.

Sincerely,

ROBERT ST. VRAIN, CLERK

Enclosure
cc: John Paul Martin
Frank Dosal, Clerk
NO. 4-89-396

United States Court of Appeals
For The Eighth Circuit

Nos. 89-5526 and 89-5585

Northwest Racquet Swim & Health Clubs, Inc., a Minnesota corporation,

Appellant,

v.

Resolution Trust Corportion, as receiver for Midwest Federal Savings and Loan Association and Midwest Savings Association, F.A.,

Appellees.

Appeals from the United States District Court for the District of Minnesota.

Submitted: September 12, 1990
Filed: February 28, 1991

Before McMILLIAN, Circuit Judge, BRIGHT, Senior Circuit Judge, and BOWMAN, Circuit Judge.

BRIGHT, Senior Circuit Judge.

Northwest Racquet Swim & Health Clubs, Inc. (Northwest) appeals the district court's[1] grant of summary judgment[2] in favor of the Resolution Trust Corporation (RTC) in this action for rescission of subordinated debt securities purchase from now insolvent Midwest Federal Savings and Loan Association (MWF). On appeal, Northwest contends that MWF's insolvency does not

[1] The Honorable Harry H. MacLaughlin, United States District Judge for the District of Minnesota.

[2] The district court's decision is reported as *Northwest Racquet Swim & Health Clubs, Inc. v. Federal Sav. & Loan Ins. Corp.*, 721 F. Supp. 211 (D. Minn. 1989).

affect its right to rescind the securities which MWF fraudulently induced it to purchase. Northwest further asserts that its post-insolvency act of rescission of the securities elevated the subordinated debt to general creditor status, entitling it to set off the debt against its promissory note obligations to MWF. We affirm the judgment of the district court and substantially agree with its well-reasoned opinion.

I. BACKGROUND

On December 29, 1987, Northwest, a developer and operator of health clubs, purchased $15 million in subordinated debt securities (Securities) in a private offering by MWF, a Minneapolis based, federally insured savings and loan association. Northwest financed its investment with funds from two promissory notes totaling $59 million which it had previously executed with MWF also in December 1987.[3] The Securities contained language expressly subordinating Northwest's claim, in the event of liquidation, "to all claims against [MWF] having the same priority as savings account holders or any higher priority."[4] Joint Appendix (J.A.) 33. The parties also entered into a subordinated debt securities agreement (Agreement) which similarly subordinated Northwest's

[3] Northwest executed the promissory notes for $10 million and $49 million on December 1 and December 10, 1987, respectively.

[4] The priority scheme governing claims against an insolvent thrift institution placed savings account holders in the sixth priority position after various administrative costs, expenses and debts associated with the appointment and operation of the receivership, various wage and benefits claims of the employees of the failed thrift, and certain government tax claims. 12 C.F.R. § 569c.11 (1989).

claim in the event of the liquidation of MWF.[5]

The Agreement specified Northwest's remedies in the event of default. Events of default included failure to make timely payment of the principal or interest due, declaration of insolvency, or the appointment of a conservator, receiver or liquidating agent. A default would also arise in the event that "any representations or warranty made in writing by or on behalf of [MWF] herein or in connection with the transactions contemplated hereby shall prove to have been false or incorrect in any material respect on the date as of which made." J.A. 36.

In the event of a default, the remedies section provided that Northwest could act to protect and enforce its rights by instituting an action in law, suit in equity, or other appropriate proceeding. However, the Agreement placed three significant limitations upon Northwest's rights, powers and remedies. First, Northwest could accelerate payment in the event of default only to the extent that such payment did not leave MWF with insufficient capital to meet regulatory capital requirements set out in 12 C.F.R. § 563.13 (1988). Second, in the event the Federal Savings and Loan Insurance Corporation (FSLIC) was appointed receiver for MWF, FSLIC would have no obligation to arrange for the assumption of the Securities. Finally, the Agreement bound Northwest to abide by the priority scheme set out in Federal Home Loan Bank

[5] In addition, Northwest executed an Offeree Statement representing that it had "sufficient knowledge and experience in financial and business matter to be capable of evaluating the merits and risks of [the] proposed investment," that is was "able to bear the economic risk of the proposed investment," and that is had "considered that it might have to hold the proposed investment for an indefinite period of time and might have to bear a complete economic loss." J.A. 177. Northwest similarly executed a Subscription Agreement in which it again stated it had "considered and understands the high degree of risk of the securities offered." J.A. 178.

Board[6] (Bank Board) regulations governing the distribution of assets in liquidation proceedings.[7]

The sale of the Securities was contingent upon Bank Board approval pursuant to 12 C.F.R. § 563.8-1 (1988), governing the issuance of subordinated debt securities by federal savings and loan associations. The Bank Board, on December 21, 1987, approved the sale and issuance of up to $25 million in MWF subordinated debt securities.

On December 31, 1987, MWF applied the Securities to its regulatory capital, where it constituted more than ten percent of MWF's total regulatory capital through November 1988.[8] In January 1989, however, the Bank Board issued a directive ordering MWF to prospectively remove the Securities from regulatory capital because Northwest had purchased them with funds it had borrowed from MWF on an unsecured basis. MWF, accordingly, did not report the Securities as regulatory capital in its 1988

[6]The Federal Home Loan Bank Board acted as the principal regulator of the federal savings and loan industry until August 9, 1989, when Title IV of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 354, became law, abolishing the Bank Board and replacing it with the Office of Thrift Supervision.

[7]Under the regulatory priority scheme, *see* note 4, the claims of subordinated debt holders like Northwest held a ninth rank priority, behind the claims of all general creditors, and ahead only of equity interest holders. 12 C.F.R. § 569c.11 (1989).

[8]Regulatory capital is the sum of, *inter alia*, reserve accounts, retained earnings, permanent common stock, securities which constitute permanent equity capital, appraised equity capital and any other nonwithdrawable accounts which constitute the institutional reserves available for satisfying the claims of depositors and other account holders. *See* 12 C.F.R. § 561.13 (1988). Pursuant to statutory authority, 12 U.S.C. § 1464(s), the Bank Board, and its successor, the Office of Thrift Supervision (OTS), sets the minimum capital requirements for the industry. Since 1973, the Bank Board or OTS has permitted thrift institutions to include long-term subordinated debt securities in their regulatory capital because such securities possess many of the characteristics of permanent capital. 54 Fed. Reg. 34,148 (1989) (commentary accompanying Final Rule amendments to regulations governing the issuance and use of subordinated debt (codified at 12 C.F.R. § 563.13 (1989))).

fourth quarter report to the Bank Board.

Publicity concerning MWF's troubled financial condition prompted Northwest, by letter dated January 25, 1989, to notify MWF that it considered the subordinated debt security to be in default. The letter stated that the events of default "include[d] but are not limited to breach of representations and warranties" made in the Agreement regarding the financial condition of MWF. J.A. 197. Northwest accordingly declared that it was exercising its remedies as set forth in the Agreement. Specifically, Northwest declared an acceleration of payment of the balance of the principal and demanded immediate payment "in the manner and with the effect provided in the Debenture Agreement." J.A. 198. Northwest also declared an immediate setoff of any remaining amount against its promissory note obligations to MWF.

On February 13, 1989, the Bank Board declared MWF insolvent after finding that its obligations to its creditors (including savings account holders) exceeded its assets. Accordingly, the Bank Board, acting pursuant to its statutory authority under 12 U.S.C. § 1464 (d)(6)(A)(i) (1988), named FSLIC as conservator of MWF. FSLIC attempted to operate MWF as a going concern. On March 10, 1989, Northwest again informed MWF by letter that it had concluded that the sale of the Securities had "involved the misrepresentation of material facts and willful failure to disclose material facts . . . pertaining to the financial condition of [MWF]." J.A. 201. This time, however, rather than assert its contractual remedies as it did in the January 25 letter, Northwest tendered the Securities in rescission and declared an immediate setoff of the amount due against the balance of the two promissory notes held by MWF.

Northwest formalized its allegations of fraud by filing the complaint giving rise to this action in April 1989. The complaint, as later amended, alleged that MWF's material misrepresentations and nondisclosures at the time of the

transaction violated state and federal securities laws.[9] Northwest asked the court to declare the Securities and the Agreement rescinded. It further sought a declaration that the rescission elevated the Securities obligation to general creditor status. According to Northwest, the elevation of the Securities to general creditor status meant that the debt possessed a mutuality of obligation with the two promissory notes, entitling it to set off the Securities against the notes.

On May 4, 1989, the Bank Board, noting that MWF's liabilities continued to exceed its assets, concluded that MWF could not be operated as a going concern. Acting under statutory authority, 12 U.S.C. § 1464(d)(6)(A) (1988); 12 C.F.R. § 547 (1988), the Bank Board appointed FSLIC as receiver for the purpose of liquidating MWF. Accordingly, FSLIC, by operation of law, took possession of MWF and succeeded to all of MWF's rights, titles, powers and privileges. *See* 12 U.S.C. §§ 1464(d), 1729 (1988). In addition, the Bank Board determined that the total liquidation of MWF would not generate sufficient funds to satisfy the claims of MWF's general creditors, thus, it formally declared all subordinated debt and equity

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[9]The financial statements appended to and incorporated into the Agreement stated that an MWF asset identified as a "Finance and Excess Service Fee Income Receivable" had a value of approximately $207 milliion. Northwest alleged that, at the time of the transaction, MWF officials knew and failed to disclose to Northwest that the asset, which is presently the subject of separate litigation, was likely worth far less than $207 million represented in the financial statements upon which Northwest based its decision to invest. Northwest asserted in its complaint that this material misrepresentation violated § 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. § 240.10b-5 (1988), and Minn. Stat. § 80A.01 (1986).

interests in MWF to be worthless.[10]

The Bank Board also contemporaneously created a new savings and loan association, Midwest Savings Association (Midwest Savings), to facilitate the liquidation of MWF and the reorganization of its assets. The Bank Board immediately placed Midwest Savings under FSLIC conservatorship. It further directed FSLIC to enter into a purchase and assumption agreement with Midwest Savings, transferring most of MWF's assets to Midwest Savings in consideration for Midwest Savings' assumption of certain MWF liabilities.

Under the purchase and assumption agreement, Midwest Savings did not assume any MWF equity liabilities or obligations, including the subordinated debt securities at issue here. As a result of this transaction, the obligations arising from the Securities remained with FSLIC, as receiver for MWF, while Midwest Savings assumed possession of the promissory notes against which Northwest sought to exercise its claimed right of setoff. Northwest accordingly amended its complaint to include Midwest Savings as a defendant and requested that the court preliminarily enjoin Midwest Savings from further selling or transferring the notes which Northwest sought to set off.

FSLIC filed a Fed. R. Civ. P. 12(b)(6) motion to dismiss for failure to state a claim. The district court, finding that the disposition of the motion turned on matters outside the pleadings, treated it as a motion for summary judgment and ruled in favor of FSLIC. The district court adopted the analysis of the Second Circuit in *In re Weis Sec., Inc.*, 605 F.2d 590 (2d Cir. 1978), *cert. denied*, 439 U.S. 1128 (1979),

[10]The settlement of claims in the event of liquidation proceeded under an absolute priority scheme, meaning that ninth and tenth priority subordinated debt and equity holders could receive treatment of their claims only after all claims of the first eight ranks had been fully satisfied. 12 C.F.R. § 569c.11(d) (1989). Thus, the Bank Board's determination that MWF's assets were insufficient to satisfy the claims of seventh priority general creditors meant that no money remained for the claims of ninth priority subordinated debt holder like Northwest.

and held, as a matter of law, that because MWF had applied the funds from the sale of the Securities to its regulatory capital accounts, Northwest was precluded from rescinding the Securities after the Bank Board had declared MWF insolvent. The Securities, therefore, remained subordinated, and thus lacked the requisite mutuality of obligation necessary to set them off against the two promissory notes.[11] Northwest filed this appeal in which it renews the arguments it presented before the district court.[12]

II. DISCUSSION

We review a grant of summary judgment under the same standard applied by the district court. *McCuen v. Polk County, Iowa*, 893 F.2d 172, 173 (8th Cir. 1989). Thus, we review the facts *de novo*, *Didier v. J.C. Penney Co.*, 868 F.2d 276 (8th Cir. 1989), and affirm the district court only if we agree that "there is no genuine issue of material fact, viewing the facts in the light most favorable to the non-moving party, and that the moving party is entitled to judgment as a matter of law." *McCuen*, 893 F.2d at 173 (citing *Kegel v. Runnels*, 793 F.2d 924, 926 (8th Cir. 1986)); *see Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 247-48 (1986).

Viewing the facts in the light most favorable to Northwest, we must assume that MWF did indeed fraudulently induce Northwest to purchase the Securities

[11] The district court also denied Northwest's motion to enjoin Midwest Savings from further selling or transferring the promissory notes because the motion was predicated upon Northwest's claimed right to set off the Securities against the notes.

[12] During the pendency of this action, Congress created the Resolution Trust Corporation (RTC) as part of its 1989 restructuring of the federal savings and loan regulatory system. *See* Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183. Under the regulatory reorganization, the RTC assumed most of the receivership, conservership and liquidation functions of the FSLIC. Consequently, RTC replaced FSLIC as receiver for MWF and conservator of Midwest Savings, and now stands in FSLIC's place as defendant and appellee in this action.

by making material mispresentations regarding its financial condition at the time of the transaction. Neither party disputes that MWF immediately applied the investment to regulatory capital. In addition, neither party disputes that, as of February 13, 1989, MWF was insolvent. On the basis of these facts, the district court held that Northwest, as a matter of law, was precluded, as of the date of MWF's insolvency, from rescinding the sale of Securities. Northwest did not attempt to rescind until March 10, 1989, nearly one month after the Bank Board's declaration of MWF's insolvency, thus it was barred from rescinding the Securities.

In reaching its decision, the district court concluded that *In re Weis Sec., Inc.*, 605 F.2d 590 (2d Cir. 1978), resolved the outcome of this case. We therefore focus our attention on *Weis*. In *Weis*, lenders to a securities broker-dealer subordinated their loans to the claims of all other creditors in exchange for a higher rate of return. The subordination, which in effect rendered the loans unencumbered for regulatory purposes, enabled Weis to comply with industry regulatory capital requirements necessary to continue operations. Following Weis' insolvency, the lenders, claiming fraud in the inducement, sought to rescind the subordination agreements.

The Second Circuit rejected the subordinateds lenders' claims, holding that because the lenders had subordinated their loans specifically to enable Weis to comply with regulatory capital requirements, they were estopped from rescinding their subordination agreements following Weis' declaration of insolvency, regardless of whether general creditors actually relied upon the subordination in extending credit to the company. The *Weis* court analogized the position of the lenders to shareholders in a series of cases arising under the old National Banking Act, in which those purchasing shares of a national bank were conclusively presumed to have known that they had increased the bank's capital and facilitated its conduct of business. 605 F.2d at 595 (construing *Scott v. Deweese*, 181 U.S. 202 (1901)). Having assumed such a position, the

shareholders were not permitted to escape their statutory liability to the banks creditors at the time of insolvency.[13]

In *Scott v. Deweese,* for example, a shareholder claiming that he was fraudulently induced to invest in a national bank sought to rescind after the bank had declared its insolvency. In rejecting the shareholder's claim, the Court stated:

> The present suit is primarily in the interest of creditors of the bank. It is based upon a statute designed not only for their protection but to give confidence to all dealing with national banks in respect of their contracts, debts and engagements, as well as to stockholders generally. If the subscriber became a shareholder in consequence of frauds practiced upon him by others, whether they be officers of the bank or officers of the Government, he must look to them for such redress as the law authorizes, and is estopped, as against creditors, to deny that he is a shareholder . . . if at the time the rights of creditors accrued he occupied and was accorded the rights appertaining to that position.

181 U.S. at 213. By analogy, the court in *Weis* held that, having assumed a subordinate position in order to enable the company to meet federally mandated regulatory capital requirements necessary to continue operations, the lenders were similarly estopped from rescinding their subordination after the date of insolvency.[14]

The district court deemed *Weis* analogous to the present action because Northwest's investment, like those of the lenders in *Weis,* was applied to the regulatory capital of

[13] Prior to 1959, shareholders of national banks were statutorily liable for the banks' obligations to the extent of the par value of their shares. 12 U.S.C. § 63 (1958) (repealed 1959).

[14] The declaration of insolvency is the critical moment in determining the relationship between various competing interests because "[i]t is well settled that the rights and liabilities of a bank and the bank's debtors and creditors are fixed at the declaration of the bank's insolvency." *American Nat'l Bank v. FDIC,* 710 F.2d 1528, 1540 (11th Cir. 1983) (citations omitted).

the issuing institution. We agree. The district court stated that *Weis* "is premised on the fact that the capital regulations reflected 'a strong desire to assure investors of the stability and integrity of the securities markets and of the broker-dealers responsible for channeling investments into them.'" *Northwest Racquet Swim & Health Clubs, Inc. v. Federal Sav. & Loan Ins. Corp.*, 721 F. Supp. 211, 216 (D. Minn. 1989) (quoting *Weis*, 605 F.2d at 596). We believe, contrary to Northwest's assertion, that the regulatory capital requirements of the thrift industry serve similar regulatory interests and purposes as those in the securities industry.

In both industries, regulatory capital acts as a cushion helping the institution to absorb losses in lean times, thus ensuring customers, investors in the securities context and depositors[15] in the savings and loan context, of the stability and integrity of the institution in which they have placed their money. *See* 53 Fed. Reg. 51,800 (proposed Dec. 23, 1988) (commentary on "Purpose of Regulatory Capital" accompanying proposed amendments to regulatory capital requirements codified at 12 C.F.R. §§ 561, 563).[16] The protection provided by regulatory capital requirements, thus, is most critical during an economic

[15] The purposes of regulatory capital requirements are typically framed in terms of the risk of loss borne by FSLIC (and now the Federal Deposit Insurance Corporation (FDIC)) rather than depositors *per se*. However, Congress created thrift deposit insurance to promote thrift and protect savings by ensuring that the "*saver* will get his money back." H.R. Rep. No. 1922, 73d Cong., 2d Sess. 3 (1934) (accompanying Title IV of the National Housing Act, codified as amended at 12 U.S.C. §§ 1724-1730i (1988), *repealed by* Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, Title IV, § 407, 103 Stat. 363) (emphasis added). It is therefore appropriate to view the interests of FSLIC as synonymous with the interests of depositors.

[16] Regulatory capital requirements also "reduce the 'moral hazard' engendered when the insurer bears most of the cost of a thrift's failure. . . [by ensuring that] initial losses are borned not by the insurer, but by the institution's equity and *subordinated debt holders, who, through their control of the institution's management, control the actions most likely to lead to insurance losses.*" 53 Fed. Reg. 51,800 (1988) (emphasis added).

downturn, and particularly in the event of insolvency. This protection would be severly undermined if, at the time when the protection was most sorely needed, claims of general creditors or depositors were made contingent upon the lower priority claims of subordinated debt and equity interest.[17]

An action for rescission by a subordinated debt holder after the date of insolvency must be viewed, in effect, as one between the investor and general creditors, including innocent depositors, *Scott v. Deweese,* 181 U.S. at 212, because the claim of the rescinding investor "can be satisfied only out of assets which otherwise would be allocated to making innocent parties whole." Slain & Kripke, *The Interface Between Securities Regulation and Bankruptcy--Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors,* 48 N.Y.U. L. Rev. 261, 286 (1973); *see also Scott v. Abbott,* 160 F. 573, 581 (8th Cir.), *cert. denied,* 212 U.S. 571 (1908); *In re Stirling Homex Corp.,* 579 F.2d 206, 213 (2d Cir. 1978), *cert. denied,* 439 U.S. 1074 (1979). It is fair to suggest, in a case such as the one now before us, that all of the parties are victims of the institution's fraud. The question thus becomes which party should receive priority in the settlement of their claims: the investor, who is in the best position to judge the condition of the thrift and

[17] We disagree with Northwest that *Oppenheimer v. Harriman Nat'l Bank & Trust Co.,* 301 U.S. 206 (1937), sanctions just such a contingency of depositor and general creditor claims. In *Oppenheimer,* the Court did permit a shareholder in a national bank to rescind his investment on the basis of the bank's fraud after the bank had declared its insolvency. However, the Court deemed the right to rescission contingent upon prior satisfaction of Oppenheimer's statutory liability to the bank's creditors. The Court allowed Oppenheimer's rescission only because he had previously satisfied his statutory obligation:

> Plaintiff appeared by the bank's records to be a stockholder and, as against creditors for whose benefit the statutory liability was created, was estopped from denying that status. Recognizing that the bank's fraud and his rescission availed nothing against the comptroller's assessment, plaintiff paid the amounts laid against him.

301 U.S. at 214.

influence its management, or the innocent depositors and general creditors.

Northwest asks that the subordinated debt holder be given an equal bite at the apple. This argument is a familiar one which brings to mind the observaton of this court many years ago that in the event of an insolvency, "the temptation to lay aside the garb of a stockholder, on one pretense or another, and to assume the role of a creditor, is very strong." *Newton Nat'l Bank v. Newbegin,* 74 F. 135, 140 (8th Cir. 1896), *quoted in In re Stirling Homex Corp.,* 579 F.2d at 213. Northwest's request overlooks the fact that the depositors and general creditors "did nothing to create the rescinder's problems and in the overwhelming majority of cases . . . reli[ed] on the existence of the equity or junior debt cushion which the rescinder purported to provide." Slain & Kripke, 48 N.Y.U. L. Rev. at 286. In such situations, fairness and equity dictate that investors, having undertaken the greater risk, give way to the depositors and general creditors by honoring the regulatory obligations they have assumed. It is the regulatory interest of protecting the innocent depositors and general creditors which drove the Second Circuit's analysis in *Weis* which we now adopt.

Northwest asserts, however, that under *Weis,* it cannot be said to have undertaken such a regulatory obligation without a showing that it subordinated its claims with the specific intent of enabling MWF to meet its regulatory capital requirements. As noted above, the lenders in *Weis* did execute the subordination agreements with the specific intention of enabling Weis to meets its regulatory capital requirements. By comparison, Northwest asserts that it did not know that MWF needed, or would use, the proceeds of the sale of the Securities for regulatory capital purposes. Northwest thus asserts that *Weis* does not apply under the facts of this case.

We agree that the specific intention of the lenders in *Weis* was a factor in the Second Circuit's decision. However, we believe that Northwest reads the implications of *Weis* too narrowly in light of the regulatory interests at

stake. While the facts of *Weis* appear to limit its application to subordinations with the specific intent of enabling a federally regulated institution to meet mandatory capital requirements, we believe its rationale extends to situations in which parties subordinate their claims in such a manner as to make the investments eligible for use as regulatory capital. Once a federally regulated institution applies such investments to its regulatory capital base, the investors must be conclusively presumed to know that they have increased the institution's capital and facilitated the conduct of its business. *See Scott v. Deweese,* 181 U.S. at 212. Any other result would undermine the regulatory protections and priorities accorded innocent third parties who rely upon stated capital reserves.

Under the standard we now enunciate, it is clear that under the facts as presently constituted, Northwest, as a matter of law, is not entitled to any relief. First, both the Securities and the Agreement were structured to render the investment available for use as regulatory capital. The Agreement expressly required that the sale be approved by the Bank Board pursuant to 12 C.F.R. § 563.8-1 (1988), which sets forth numerous terms and conditions for the issuance of subordinated debt securities. Subordinated debt securities meeting the terms and conditions of § 563.8-1 were eligible for use as regulatory capital. 12 C.F.R. § 561.13(c)(1) (1988) ("The term 'regulatory capital' also includes subordinated debt securities issued pursuant to § 563.8-1").

Section 563.8-1 expressly employs the term "regulatory capital" in conjunction with subordinated debt securities. *See* 12 C.F.R. § 563.8-1(b)(2)(i) (1988).[18] This provision suggests to us that a subordinated investor such as Northwest should recognize the link between subordinated debentures and regulatory capital, and, more to the point,

[18] We also note that the regulatory capital requirements set out at 12 C.F.R. § 563.13 were expressly referred to in both the regulation governing the approval of the sale of the Securities, and the Agreement itself.

that this sort of investment might be applied to regulatory capital. We also consider telling the language in the Agreement, as required by the regulations, 12 C.F.R. § 563.8-1(d)(1)(iv) (1988), clearly stating that no payment of principal shall be accelerated without approval of the Bank Board if such payment would leave MWF with insufficient regulatory capital. In agreeing to this provision, Northwest, again, expressly limited its rights and remedies to those available to contributors to regulatory capital. Finally, Northwest agreed to subordinate its claims to those claims having the same priority as savings account holders or higher, again a condition of investments to be devoted to regulatory capital. *See* 12 C.F.R. § 563.8-1(d)(1)(ii) (1988). Having agreed to terms and conditions that made its investment eligible for use as regulatory capital, Northwest should now now be heard to complain that it was in fact used in this manner.[19]

Having determined that Northwest clearly subordinated its investment in a manner that made it eligible for use as regulatory capital, we next look to the record to determine whether the funds, in fact, were used for that purpose. On this issue, there is no dispute. MWF included the investment in regulatory capital beginning in the fourth quarter of 1987 and continuing at least through the third quarter of 1988. We should note that the Bank Board's January 1989 directive instructing MWF to remove the Securities from its reported regulatory capital does not affect our analysis. The Bank Board directed MWF to remove the Securities from regulatory capital only *prospectively.* The purely prospective nature of the action means that, for regulatory purposes, the Securities must

[19] If Northwest had alleged that, at the time of the transaction, MWF specifically indicated that the money would not be used for regulatory capital purposes, then we might view this case differently. However, that is not the case we have before us. Northwest has merely asserted that MWF did not expressly state that the investment would be used as regulatory capital. This allegation simply does not create a genuine issue of material fact in light of the terms of the Agreement.

be regarded as regulatory capital from December 1987 until November 1988. Thus, in the final analysis, Northwest's investment must be regarded as fully encumbered by the regulatory obligation to remain subordinate to the claims of depositors and general creditors in the event of insolvency.[20]

In holding that Northwest may not rescind, we emphasize that we do not hold that a subordinated investor who has agreed to terms and conditions that make his investment eligible for inclusion in regulatory capital never has recourse for fraud. We hold only that such investors may not rescind after the issuing institution has been declared insolvent.[21] The continuing subordinated status of the Securities means that they lack the requisite mutuality of obligation required to set them off with the promissory note which possesses a superior

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[20] Had the Bank Board ordered the removal of the Securities from MWF's regulatory capital account retrospectively as well as prospectively, this case might have more closely resembled *FDIC v. United States Nat'l Bank,* 685 F.2d 270 (9th Cir. 1982), upon which Northwest relies. In *United States Nat'l Bank,* the court permitted a subordinated debt holder to rescind its fraudulently induced investment in a bank despite the fact that the debt holder did not rescind until after the bank has been declared insolvent. The FDIC, as receiver for the insolvent bank, argued that *Weis* should apply and that no rescission should be permitted post-insolvency. However, National Banking Act regulations governing the subordinated loan at issue in *United States Nat'l Bank* prohibited the use of subordinated debt as regulatory capital. In other words, there were no regulatory interests at stake in *United States Nat'l Bank.* Thus, the court ruled that *Weis,* in which the subordinated loans could be, and were, used as regulatory capital, was distinguishable and did not apply. For the very reason that the court in *United States Nat'l Bank* concluded that *Weis* did not apply, we conclude that *United States Nat'l Bank* must be distinguished on its facts and does not apply in the present case.

[21] RTC has asserted that Northwest bound itself to an exclusive set of remedies to apply even in the event of fraud in the inducement, thus suggesting that Northwest could not have rescinded even prior to the date of insolvency. Our holding does not require us to pass judgment on this issue.

general creditor rank.[22]

III. CONCLUSION

For the reason expressed above, we affirm the judgment of the district court.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT.

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[22] Generally, the right to setoff exists only as to mutual debts. *See, e.g., Sioux Line R.R. v. Escabana & Lake Superior R.R.,* 840 F.2d 546, 551 (7th Cir. 1988). To exhibit the requisite mutuality, the debts must be in the same right. *See* 5A Michie, *Banks & Banking* ch. 9, § 115c (1983). Subordinated debentures do not exist in the same right as promissory notes, thus, they may not be set off against each other. *See FDIC v. Texarcana Nat'l Bank,* 874 F.2d 264, 268-69 (5th Cir. 1989) (subordinated debentures in insolvent bank do not, as a matter of both law and equity, meet mutuality of obligation test); *see also FDIC v. de Jesus Velez,* 678 F.2d 371 (1st Cir. 1982) (subordinated debentures in insolvent bank not mutually extinguishable with promissory notes).

United States District Court

District of Minnesota

FOURTH DIVISION

Northwest Racket Swim & Health Clubs, Inc., a Minnesota corporation,

Plaintiff,

v.

Federal Savings and Loan Insurance Corporation as receiver for Midwest Federal Savings and Loan Association, a United States corporation, and Midwest Savings Association, F.A.,

Defendants.

CIVIL 4-89-396

MEMORANDUM AND ORDER

Phillip A. Cole, Lommen, Nelson, Cole & Stageberg, P.A., 1100 TCF Tower, 121 South Eighth Street, Minneapolis, MN 55402, Ronald L. Haskvitz, James M. Lockhart, Smith, Juster, Freikema, Malmon & Haskvitz, 1000 IDS Center, 80 South Eighth Street, Minneapolis, MN 55402, for plaintiff.

Jeffrey G. Stephenson, John E. Yanish, John Paul Martin, Petersen, Tews & Squires, P.A., 4800 IDS Center, 80 South Eighth Street, Minneapolis, MN 55402-2208, for defendants.

This matter is before the Court on two motions: the motion of the Federal Savings and Loan Insurance Corporation (FSLIC) to dismiss all claims against it in its role as conservator for Midwest Savings Association, F.A. and the motion by Northwest Racquet Swim and Health Clubs, Inc., (Northwest) for a preliminary injunction. The Court will grant the FSLIC's motion to dismiss and deny Northwest's motion for a preliminary injunction.

FACTS

Plaintiff Northwest is a corporation engaged in the business of developing and operating health clubs. The named defendants are Midwest Federal Savings and Loan Association (MFW), which is under the receivership of FSLIC, and Midwest Savings Association, F.A. (MSA), a savings and loan association created in May 1989 after MWF was found to be unable to continue as a going concern.

On December 29, 1987, MWF sold to Northwest an investment of $15 million in a subordinated debt security (the security). Amended Complaint par. 6 and Exh. A. The security is replete with language establishing that it is a subordinated debt. The security is titled, SUBORDINATED DEBT SECURITY, and the last paragraph on the first page states, in capital letters, that the security is not eligible to be held by any institution whose accounts are insured by the FSLIC.[1] Amended Complaint Exh. A. at 1. The front page of the security also states:

> Payment of the principal of an interest on this Note is subordinated on liquidation as to principal and interest to all claims (including post-default interest) against [MWF] having the same priority as savings account holders or any higher priority and the Note shall be subordinated to such other claims against [MWF] as more particularly described in the Subordinated Debt Securities Agreement.

Id. The security also contains an explicit subordination in the event that MWF is no longer able to continue as a going concern.

> If the FSLIC shall be appointed receiver for [MWF] and in its capacity... shall arrange for the assumption of less than all of the liabilities of [MWF] by one or

[1] The paragraph states that the security can be held by any diversified savings and loan holding company and any non-FSLIC insured institution subsidiary thereof. Amended Complaint Exh. A at 1.

> more other insured institutions, the FSLIC shall have no obligation, either in its capacity as receiver or in its corporate capacity, to contract for or to otherwise arrange for the assumption of the obligation represented by this Note in whole or in part.... To the extent that the obligations represented by this Note have not been assumed in full by an insured institution . . . the holder of this Note shall be entitled to payments on this obligation in accordance with the procedures and priorities set forth in the Federal Home Loan Bank Board's regulations as they may be applicable to the receivership of [MWF] or as they may be set forth in orders of the Federal Home Loan Bank Board relating to such receivership.

Id. at 2.

There is a separate subordinated securities agreement signed by the parties which also explicitly provides for subordination.

> Payment of the principal of and interest on the Notes is hereby expressly subordinated on liquidation to all claims (including post default interest) against [MWF] having the same priority as savings account holders or any higher priority.

Amended Complaint Exh. B at 14. The agreement defines a material misrepresentation on the part of MWF as an event of default. *Id.* at 17. The paragraph which defines the holder's remedies in the event of default also provides that should the FSLIC be appointed as receiver for MWF the FSLIC would have no obligation to arrange for the assumption of the security, using the same language quoted above from page two of the security. *Id.* at 20-21.

Defendants assert that the purpose of the subordination was to permit the moneys generated by the sale of the securities to be used to enable MWF to comply with the regulatory capital requirements. In response to this assertion, Marvin Wolfenson, the president of Northwest, and Harvey Ratner, Northwest's secretary, have filed affidavits stating that at no time did anyone speaking on

behalf of MWF "state or imply that a subordinated debt investment by [Northwest] was necessary either to meet regulatory financial requirements or to allow [MWF] to continue in business." Affidavit of Marvin Wolfenson at par. 2 and Affidavit of Harvey Ratner at par. 2.

MWF had, in fact, applied to have the subordinated debentures that were sold to Northwest included in its regulatory capital. Affidavit of Steven L. Opsal par. 4-6. From December 31, 1987 through November 1988, the subordinated debentures issued to Northwest constituted more than ten percent of MWF's regulatory capital. Opsal Aff. par. 9. In January 1989, however, the FSLIC directed MWF to prospectively remove the subordinated debenture securities purchased by Northwest from its regulatory base. Opsal Aff. par. 10. This action was taken because it appeared that the subordinated debentures may have been purchased with funds loaned to Northwest by MWF on an unsecured basis. *Id.*

On January 25, 1989, Northwest reacted to reports concerning MWF's financial troubles by advising MWF that it considered the subordinated debt security to be in default by virtue of a "breach of representations and warranties" and a "failure to furnish financial statements and certificates" in accordance with the agreement. Affidavit of James M. Lockhardt Exh. 6, January 25, 1989 Letter from Marvin Wolfenson to Harold W. Greenwood, Jr. On that ground, Northwest declared an immediate setoff of the entire unpaid balance of the security against amounts due from Northwest under two promissory notes held by MWF.[2] *Id.*

On February 13, 1989, the Federal Home Loan Bank Board (Bank Board), which regulates federally charterd thrifts, determined that MWF was insolvent and appointed the FSLIC as the conservator for MWF. Affidavit of David A. Yonke Exh. A. At this point, the FSLIC attempted

[2]The two promissory notes were a note dated December 10, 1987 in the original principal amount of $49 million and a note dated December 1, 1988 in the original principal amount of $10 million. Affidavit of Mark McMullen par. 3.

to operate MWF as a going concern.

On March 10, 1989, Northwest sent another letter to MWF. Lockhardt Aff. Exh. 7, March 10, 1989 Letter of Robert A. Stein. This letter stated that Northwest now had reasonable grounds upon which to conclude that the sale of the subordinated debt security "involved the misrepresenation of material facts and willful failure to disclose material facts known to [MWF], pertaining to the financial condition of [MWF]." *Id.* As a result, in its letter Northwest attempted to rescind the subordinated debt security agreement. *Id.* Northwest further declared an immediate setoff against the two promissory notes mentioned in the January 25th letter. *Id.* On April 19, 1989, Northwest commenced this action against MWF.[3] in the action, Northwest alleges that material misrepresentations and nondisclosures by MWF constitute violations of state and federal securities law. It seeks rescission of the subordinated debt security agreement and declaration of its right to set off the entire unpaid balance of the security against amounts due from Northwest under the two promissory notes.

On May 4, 1989, the Bank Board determined that MWF's assets were less than its obligations to creditors and that, therefore, MWF could not continue to be operated as a going concern. Affidavit of Richard Galecki, Exh. B. Consequently on that same date, the Bank Board appointed the FSLIC as receiver for MWF. The receiver took possession of MWF immediately and, by operation of law, succeeded to all of MWF's rights, titles, powers and priviliges. *See* 12 C.F.R. § 547.7.

On the same date, the Bank Board created a new savings and loan association, MSA, and directed FSLIC as the receiver of MWF to transfer, in a purchase and assumption transaction, the majority of MWF's assets in consideration for the assumption by MSA of certain liabilities of MWF. Galecki Aff. Exh. C-E. According to

[3]The action was originally filed in the state district court and subsequently removed to this Court on the petition of the FSLIC.

the terms of the acquisition agreement, MSA did not assume any liability or obligations relating to equity holders in MWF, including the subordinated debt security at issue here. Galecki Aff. Exh. E at § 2.

As a result of these transactions, the obligation on the subordinated debt security is now held by the FSLIC as receiver for MWF. The promissory notes against which Northwest claims a right of setoff are held by MSA. FSLIC also acts in this litigation as conservator for MSA.

DISCUSSION

I. Motion to Dismiss All Claims Against MSA

The FSLIC as conservator for MSA moves for dismissal of the claims Northwest advances against MSA. In its complaint, Northwest seeks an order rescinding the subordinated security agreement and a declaration that the amount due Northwest upon rescission be set off against the promissory notes now held by MSA. Northwest argues that it is entitled to rescission because of false representations and misleading omissions by MWF in the sale of the subordinated debt security. Northwest's position is that a rescission due to fraud in the sale of a subordinated debt security elevates the holder of the security to the status of a general creditor. This elevation in status creates the mutuality of obligation necessary to allow Northwest to set off the amount due on the security against the promissory notes originally held by MWF. Although those notes are now held by MSA, Northwest argues that its right to setoff was effective at the moment of MWF's insolvency and therefore MSA took the notes subject to the setoff.

Although FSLIC brings its motion to dismiss under Fed.R. Civ.P. 12(b) (6), the motion is more appropriately analyzed as a motion for summary judgment under Fed.R.Civ.P. 56 because its disposition turns on matters outside the pleadings.

A movant is not entitled to summary judgment unless

the movant can show that no genuine issue exists as to any material fact. Fed.R.Civ.P. 56(c). In considering a summary judgment motion, a court must determine whether "there are any genuine factual issues that properly can be resolved only by a finder of fact because they may reasonably be resolved only by a finder of fact because they may reasonably be resolved in favor of either party." *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 250 (1986). The role of a court is not to weigh the evidence but instead to determine whether, as a matter of law, a genuine factual conflict exists. *AgriStor Leasing v. Farrow,* 826 F.2d 732, 734 (8th Cir. 1987). "In making this determination, the court is required to view the evidence in the light most favorable to the nonmoving party and to give that party the benefit of all reasonable inferences that can be drawn from the facts." *AgriStor Leasing,* 826 F.2d at 734. When a motion for summary judgment is properly made and supported with affidavits or other evidence as provided in Fed.R.Civ.P. 56(c), then the nonmoving party may not merely rest upon the allegations or denials of the party's pleading, but must set forth specific facts, by affidavits or otherwise, showing that there is a genuine issue for trial. *Lomar Wholesale Grocery, Inc. v. Dieter's Gourmet Foods, Inc.,* 824 F.2d 582, 585 (8th Cir. 1987), *cert. denied,* 108 S.Ct. 707 (1988). Moreover, summary judgment must be entered against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial. *Celotex Corp. v. Catrett,* 477 U.S. 317, 324 (1986).

The right to setoff exists only as to mutual debts. *Soo-Line Railroad Co. v. Escabana & Lake Superior Railroad Co.,* 840 F.2d 546, 551 (7th Cir. 1988); *Onsen-Frankman Livestock Marketing Service, Inc. v. Citizens National Bank,* 605 F.2d 1082, 1087 (8th Cir. 1979). The debt security purchased by Northwest is, however, subordinated to all claims against MWF having the same or higher priority as savings account holders and therefore not mutual with respect to the promissory notes. Northwest

seeks to establish mutuality on the strength of *Oppenheimer v. Harriman National Bank and Trust Co.*, 301 U.S. 206 (1937). Relying on that case, Northwest argues that the holder of a subordinated debt security is elevated to the status of a general creditor upon a showing of fraudulent inducement in the sale of the subordinated security.

In *Oppenheimer,* the Court held that the defrauded purchasers of stock in a national bank were entitled to rescission and the same priority as the other unsecured creditors of the bank. 301 U.S. at 213. However, the plaintiff's right to parity with other unsecured creditors accrued only after he fully discharged his liability as a stockholder by payment of the statutory liability to those creditors.

> Plaintiff appeared by the bank's records to be a stockholder and, as against creditors for whose benefit the statutory liability was created, was estopped from denying that status. Recognizing that the bank's fraud and his rescission availed nothing against the comptroller's assessment, plaintiff paid the amount laid against him.

301 U.S. at 214; *see In re Weis Securities, Inc.,* 605 F.2d 590, 596 n.12 (2d Cir. 1978), *cert. denied,* 439 U.S. 1128 (1979).

The United States Court of Appeals for the Second Circuit has applied the rule of *Oppenheimer* in the context of a subordinated lender whose loan was used to enable a securities broker to meet regulatory capital requirements. *In re Weis Securities,* 605 F.2d 590 (2d Cir. 1978), *cert. denied,* 439 U.S. 1128 (1979). *Weis* involved lenders who had made loans to Weis, a "broker-dealer," under agreements which subordinated the loans to the claims of any general creditor of Weis. 605 F.2d at 593. The subordination agreements enabled Weis to comply with the net capital rules of the Securities Exchange Commission and of the New York Stock Exchange. *Id.*

Weis became insolvent and the lenders sought to rescind

their subordination agreements because of fraud on the part of Weis. The lenders argued that, absent a showing that Weis' customers relied upon the subordination agreements, rescission should place the lenders in the same position as the unsubordinated creditors and customers. 605 F.2d at 594. The Second Circuit rejected this argument and held that where a loan was subordinated in order to enable a securities broker to comply with regulatory capital requirements, the lender will be estopped from rescinding the subordination agreement. 605 F.2d at 596. The court's holding is premised on the fact that the capital regulations reflected "a strong desire to assure investors of the stability and integrity of the securities markets and of the broker-dealers responsible for channeling investments into them." 605 F.2d at 596. To make the priority of a broker-dealer's customers contingent "on anything" would undermine this important objective. 605 F.2d at 596.

In reaching this conclusion, the Second Circuit relied on *Scott v. Deweese,* 181 U.S. 202 (1901) in which the plaintiff sought to rescind a purchase of bank stock on the ground that the purchase had been fraudulently induced. The Court estopped plaintiff from rescinding on the ground that a purchaser of bank shares must be conclusively presumed to have known that he had increased the bank's capital and facilitated its conduct of business. 181 U.S. at 212. The shareholder's redress for the fraud was against those who practiced it upon him, not against the bank's creditors. 181 U.S. at 213.

The only case besides *Oppenheimer* in which a defrauded equity holder was held entitled to rank on parity with unsecured creditors is *FDIC v. United States National Bank,* 685 F.2d 270 (9th Cir. 1982).[4] In that case, the court agreed with *Weis* court's reading of *Oppenheimer*

[4] Recognizing the similarities between the functions of the two agencies, federal courts regularly rely upon cases involving the FDIC when deciding cases to which the FSLIC is a party. *See, e.g., FSLIC v. Murray,* 853 F.2d 1251, 1254 (5th Cir. 1988); *FSLIC v. Burdette,* 696 F.Supp. 1183, 1188 (E.D.Tenn. 1988).

but specifically found that the subordinated loans issued did not function to enable the bank to comply with regulatory capital requirements. 685 F.2d at 274-75.

Northwest argues that *Oppenheimer* should be interpreted as allowing a subordinated lender to be elevated to the status of a general creditor upon rescission, except where the subordination agreement was entered with the express understanding that it served to maintain regulatory capital above the required level. That is not, however, a fair reading of the case. *Oppenheimer* granted the equity holder parity with unsecured creditors only after the equity holder had fully satisfied his obligations to those creditors. The fraud of the bank which sold plaintiff the stock and the plaintiff's recision "availed nothing against the comptroller's assessment," 301 U.S. at 214, which established the full extent of the stockholders' liability to the bank's creditors. 301 U.S. at 215.

This case is perfectly analogous to *Weis.* Northwest's subordinated debenture was reported as part of MWF's regulatory capital. Regulatory capital requirements serve to bolster public confidence in savings and loans by assuring creditors that they can rely on the stated capital resources of the savings and loan. A subordinated lender whose loan enables a savings and loan to meet regulatory requirements is an equity holder whole investment can, if worst comes to worst, be used to satisfy the claims of customers. *Weis,* 605 F.2d at 595-96. Thus, the subordinated lender is properly estopped from rescinding its obligations. 605 F.2d at 596.

It is irrelevant whether or not Northwest's principals actually knew that MWF planned to report the subordinated debentures as regulatory capital. Northwest subordinated the debentures to "all claims (including post-default interest) against [MWF] having the same priority as savings account holders or any higher priority." Amended Complaint Exh. A at 1. Northwest is conclusively presumed to know that its debentures increased MWF's capital and facilitated the conduct of its business. *See Scott v. Deweese,* 181 U.S. 202, 212 (1901).

Nor is it relevant that the FSLIC directed MWF to remove the subordinated debentures purchased by Northwest from its reported regulatory capital. That action was taken because it was suspected that the debentures may have been purchased with an unsecured loan from MWF. This was a prospective action by the regulatory agency to insure that MWF was not reporting an inflated capital base. It should not serve to unwittingly diminish the actual capital available to MWF's creditors.

Any other result would undermine the Bank Board's ability to prioritize claims. The liquidation of MWF was conducted pursuant to section 5(d) of the Home Owners Loan Act, 12 U.S.C. § 1464(D); section 406 of the National Housing Act, codified as amended at 12 U.S.C. § 1729; and 12 C.F.R. §§ 547, 549 and 569. The power of the Bank Board to prioritize claims in the course of such a liquidation is well established. In *Bean v. Independent American Savings Ass'n,* 838 F.2d 739 (5th Cir. 1988), the Fifth Circuit observed that "the process of liquidating the institution's assets and paying creditors involves the setting of priorities for claims." 838 F.2d at 742. Given the Bank Board's finding that MWF's assets were less than its obligations to "its creditors and others, including the holders of its withdrawable accounts," Yonke Aff. Exh. B at 2, the established priorities in the Bank Board's regulations leave holders of subordinated debt without any distribution from MWF.

A regulatory scheme which grants a lower priority to the financial institution's equity holders than its creditors is consonant with the priority rules governing non-Bank Board liquidations. The holders of equity are distinguished from other creditors because of differences in the risks and benefits assumed. Slain and Kripke, *The Interface Between Securities Regulation and Bankruptcy -- Allocating the Risk of Illegal Securities Issuance Between Security Holders and the Issuer's Creditors,* 48 N.Y.U.L.Rev. 261, 286 (1973). A purchaser of equity accepts equity-type rewards in exchange for equity-type risks, but general creditors do not.

> In theory, the general creditor asserts a fixed dollar claim and leaves the variable profit to the stockholder; the stockholder takes the profit and provides a cushion of security for payment of the lender's fixed dollar claim. The absolute priority rule reflects the different degree to which each party assumes a risk of enterprise insolvency; no obvious reason exists for reallocating that risk.

Id. at 286-87. Under the absolute priority rule, no class of creditor may receive anything of value until senior classes have received full compensation for the value of their claims. *In re U.S. Financial, Inc.,* 648 F.2d 515, 519 (9th Cir. 1980), *cert. denied,* 451 U.S. 970 (1981). Only after all creditors have been paid is a distribution made to the stockholders. *In re Stirling Homex Corporation,* 579 F.2d 206, 211 (2d Cir. 1978), *cert. denied,* 439 U.S. 1074 (1979).

The Second Circuit analyzed whether stockholders with claims based on fraud should be subordinated to the claims of the corporation's ordinary unsecured creditors in *Stirling Homex.* The court answered that question in the affirmative, noting that as a general rule "equity prefers the claims of innocent general creditors over the claims of shareholders or subordinated creditors deceived by officers of the corporation." 579 F.2d at 213. The court went on to state:

> This general rules is altogether fitting. When persons or institutions lend money to a corporation, or otherwise become its creditors, they do so in reliance upon the protection and security provided by the money invested by the corporation's stockholders -- the so-called "equity cushion." In effect, when stock is purchased, the purchaser of that stock invites other segments of the business world to do business with the issuer.

579 F.2d at 213-14. The rule should apply with equal force whenever equity is provided in a form designed to meet regulatory requirements intended to enhance the stability

and integrity of the savings and loan system. *See FDIC v. Bank of America Nat'l Trust and Savings Ass'n,* 701 F.2d 831, 837-39 (9th Cir.) (bank holding subordinated note of an insolvent bank cannot set off deposits against the note because the note functioned as part of insolvent bank's capital), *cert. denied,* 464 U.S. 935 (1983); *Weis,* 605 F.2d at 596 (2d Cir. 1978) (purpose of regulatory capital rule would be undermined if subordination agreement which permitted loan proceeds to satisfy capital requirements was held to be contingent).

II. Northwest's Motion for a Preliminary Injunction

Northwest has moved for a preliminary injunction enjoining the sale or transfer of the promissory notes alleged to be subject to Northwest's claim for setoff. Northwest also moves for an order allowing it to make interest payments on one of the notes to the Court. In light of the analysis above, both motions will be denied. The determination that Northwest cannot establish a right to set off the unpaid balance owed on the subordinated debentures against the promissory notes held by MSA is dispositive of the motion for a preliminary injunction, as Northwest has acknowledged. *See* Plaintiff's Reply Memorandum at 6 ("[c]learly the issue is reduced to the merit of plaintiff's right to setoff").

III. CONCLUSION

Why Northwest made the investment in question is shrouded with some mystery. However, Northwest was clearly and fully informed that the security it purchased from MWF was a subordinated debt. While much has changed at MWF since this ill-fated investment, Northwest must be held to the terms of its agreement.

Accordingly, based on the foregoing, and upon all the files, records and proceedings in this case,

IT IS ORDERED that:

1. the motion for summary judgment by the FSLIC as conservator for MSA is granted;

2. all claims advanced by Northwest against MSA are dismissed; and

3. Northwest's motion for a preliminary injunction is denied.

Judge Harry H. MacLaughlin
United States District Court

DATED: September 25, 1989

United States District Court

District of Minnesota

FOURTH DIVISION

Northwest Racquet Swim & Health Clubs, Inc., a Minnesota corporation,

Plaintiff,

v.

Resolution Trust Corporation, as receiver for Midwest Federal Savings and Loan Association, a United States corporation,

Defendant.

CIVIL 4-89-396

ORDER

Phillip A. Cole, Lommen, Nelson, Cole & Stageberg, P.A., 1100 TCF Tower, 121 South Eighth Street, Minneapolis, MN 55402, Ronald L. Haskvitz, James M. Lockhart, Smith, Juster, Freikema, Malmon & Haskvitz, 1000 IDS Center, 80 South Eighth Street, Minneapolis, MN 55402, for plaintiff.

Jeffrey G. Stephenson, John E. Yanish, John Paul Martin, Petersen, Tews & Squires, P.A., 4800 IDS Center, 80 South Eighth Street, Minneapolis, MN 55402-2208, for defendant.

This matter is before the Court on the motion of defendant Resolution Trust Corporation for summary judgment. The motion is granted and final judgment entered in this case. A memorandum opinion will follow.

Judge Harry H. MacLaughlin
United States District Court

DATED: November 22, 1989

United States District Court

District of Minnesota

FOURTH DIVISION

Northwest Racquet Swim & Health Clubs, Inc., a Minnesota corporation,

Plaintiff,

v.

Resolution Trust Corporation, as receiver for Midwest Federal Savings and Loan Association, a United States corporation,

Defendant.

CIVIL 4-89-396
MEMORANDUM

Phillip A. Cole, Lommen, Nelson, Cole & Stageberg, P.A., 1100 TCF Tower, 121 South Eighth Street, Minneapolis, MN 55402, Ronald L. Haskvitz, James M. Lockhart, Smith, Juster, Freikema, Malmon & Haskvitz, 1000 IDS Center, 80 South Eighth Street, Minneapolis, MN 55402, for plaintiff.

Jeffrey G. Stephenson, John E. Yanish, John Paul Martin, Petersen, Tews & Squires, P.A., 4800 IDS Center, 80 South Eighth Street, Minneapolis, MN 55402-2208, for defendant.

This opinion explains the basis for the Court's order of November 22, 1989 which granted the motion of defendant Resolution Trust Corporation for summary judgment.

FACTS

The relevant factual background is provided in the Memorandum and Order of September 25, 1989. Very briefly, plaintiff Northwest Racquet, Swim & Health Clubs, Inc. (Northwest) purchased a $15 million subordinated debenture from the Midwest Federal Savings and Loan Association (MWF). MWF has since been declared insolvent by the Federal Home Loan Bank Board (Bank Board). The Federal Savings and Loan Insurance Corporation (FSLIC) was appointed receiver for MWF. Through a purchase and assumption transaction, the FSLIC transferred most of MWF's assets to a new savings and loan association, Midwest Savings Association, F.A. (MSA).

The subordinated debentures purchased by Northwest remained with MWF. However, after the purchase and assumption transaction, the Bank Board determined that MWF's remaining assets were insufficient to satisfy its general creditors and thus Northwest's debentures and all of MWF's subordinated debt was "worthless." Affidavit of Richard E. Galecki, Exh. B, Federal Home Loan Bank Board Resolution No. 88-1388 at 3. Subsequently, Northwest brought this suit for recission of the subordinated debentures and setoff against two promissory notes issued by MWF and transferred in the purchase and assumption transaction to MSA. Northwest alleged that MWF had, during the course of the sale of the subordinated debentures, made material misrepresentations and nondisclosures in violation of federal and state securities law.

On June 28, 1989 the Court heard argument on two motions: a motion for summary judgment by the FSLIC as conservator for MSA and a motion by Northwest for a preliminary injunction enjoining the sale or transfer of the promissory notes alleged to be subject to Northwest's claim for setoff. The Court granted the motion for summary judgment as to MSA and denied Northwest's motion for a preliminary injunction. Memorandum and Order dated September 25, 1989.

Northwest's claim against the MSA was based upon the argument that a rescission due to fraud elevates a subordinated creditor to the status of a general creditor. In order for Northwest to set off the amounts it was owed on the subordinated debentures against its obligations on the promissory notes, Northwest needed to achieve the status of a general creditor because the right to setoff exists only as to mutual debts. Northwest took the position that, under *Oppenheimer v. Harriman National Bank and Trust Co.*, 301 U.S. 206 (1937), a rescission due to fraud in the sale of a subordinated debt security elevates the holder of the security to the status of a general creditor.

In *Oppenheimer*, the Supreme Court held that a defrauded purchaser of stock in a national bank was entitled to rescission and the same priority as the other unsecured creditors of the bank. 301 U.S. at 213. However, the plaintiff's right to parity with other unsecured creditors accrued only after he fully discharged his liability as a stockholder by payment of the statutory assessment to those creditors.

> Plaintiff appeared by the bank's records to be a stockholder and, as against creditors for whose benefit the statutory liability was created, was estopped from denying that status. Recognizing that the bank's fraud and his rescission availed nothing against the comptroller's assessment, plaintiff paid the amount laid against him.

301 U.S. at 214 (footnote omitted); *see In re Weis Securities, Inc.*, 605 F.2d 590, 596 n.12 (2d Cir. 1978), *cert. denied*, 439 U.S. 1128 (1979).

This Court interpreted *Oppenheimer* to grant an equity holder parity with unsecured creditors only after the equity holder had fully satisfied his obligations to unsecured creditors. That interpretation is in accord with decisions of the Courts of Appeals for the Second and Ninth Circuits. *In re Weis Securities, Inc.*, 605 F.2d 590, 596 n.12 (2d Cir. 1978), *cert. denied*, 439 U.S. 1128 (1979);

FDIC v. United States National Bank, 685 F.2d 270 (9th Cir. 1982). Because Northwest was subordinated lender whose loan enabled MWF to meet regulatory capital requirements, Northwest was estopped from rescinding the subordinated debt agreement. *See In re Weis Securities,* 605 F.2d at 596. Because Northwest could not rescind, it could not achieve the status of a general creditor and could not set off the amount due on the subordinated debentures against the promissory notes held by MSA. Therefore, summary judgment was granted on all claims against MSA.

The Resolution Trust Corporation (RTC) has succeeded the FSLIC as receiver for MWF. In the pending motion, the RTC moves for summary judgment on the claims against MWF. The RTC argues that, without the remedy of setoff, Northwest has no remedy against MWF even if it should prevail on its securities fraud claims.

DISCUSSION

Summary judgment is appropriate where there is no genuine issue as to any material fact and the moving party is entitled to a judgment as a matter of law. Fed.R.Civ.P. 56(c). The RTC argues that, given the Court's September 25, 1989 Order, there is no remedy available to Northwest for its securities fraud claims against MWF. The request for relief contained in Northwest's complaint is limited to recision and setoff. Amended Complaint at 10-11. As discussed above, the September 25, 1989 Order held that Northwest could not rescind the subordinated debt security agreement. Because Northwest cannot rescind that agreement, it remains a subordinated creditor of MWF and cannot set off the amount due on the subordinated debentures against its obligations under the promissory notes. Summary judgment on Northwest's claims against the RTC as receiver for MWF is therefore appropriate.

Northwest does not argue with this analysis. In fact, in Northwest's earlier memorandum in support of its motion

for a preliminary injunction, Northwest declared that a setoff against the promissory notes held by MSA "would appear to be" Northwest's only remedy. Plaintiff's Memorandum of Law in Support of Motion for Preliminary Injunction at 8.

Northwest instead argues that the better course of action would be for the Court to certify for appeal the September 25, 1989 Order granting summary judgment to MSA and stay the litigation against MWF pending the outcome of the appeal. The Court disagrees. There is no reason why final judgment should not be entered in this case.[1]

Judge Harry H. MacLaughlin
United States District Court

DATED: December 5, 1989

[1] Judgment was entered in the Court's order of November 22, 1989.